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No. 92-1907

In The

Supreme Court of the United States

October Term, 1992

HUNTINGTON BREAKERS APARTMENTS, LTD., a partnership, WILMORE CITY DEVELOPMENT, INC., a corporation, and JOSEPH P. MAYER III,

Petitioners,

vs.

C.W. DRIVER, a partnership,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of The State Of California, Fourth Appellate District, Division Three

BRIEF OF RESPONDENT C.W. DRIVER IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW:

Petitioners' alleged "Question Presented for Review" is purely hypothetical and makes incorrect assumptions. In the case at bar, there is no illegal agreement, the agreement in question does not violate the principle of *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942), there is no federal agency or lender to be protected and there is no federal law or question for determination by the Supreme Court of the United States. The transaction is complete and all that remains in this case is for Petitioners, real estate developers, to pay their contractor, Respondent herein, the $1,575,535 balance due for work performed in 1985 on their 342 apartment project as determined by three competent and experienced Arbitrators after a 130 day, 4 year arbitration trial.

PARTIES TO THE PROCEEDING.

Petitioners are real estate developers, composed of HUNTINGTON BREAKERS APARTMENTS, LTD., a California limited partnership, and its two general partners, WILMORE CITY DEVELOPMENT, INC., a California corporation and JOSEPH P. MAYER III (hereinafter collectively "BREAKERS"). Respondent C.W. DRIVER (hereinafter "DRIVER") is a California general partnership and licensed general building contractor.

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BRIEF OF RESPONDENT C.W. DRIVER IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. PRELIMINARY STATEMENT

1. Proceedings Below:

After the trial court in *1986* granted DRIVER'S motion to compel arbitration and *after* over 130 days of arbitration hearings culminating in a unanimous $3,021,502 award by three arbitrators in favor of DRIVER in *1990*, BREAKERS in *1991* for the *first time* raised the

issue of an illegality in a collateral Guarantee executed by them.

Based upon an alleged illegality in BREAKERS' Guarantee, the trial court on July 12, 1991 vacated the arbitration award, despite BREAKERS' total failure to demonstrate that the Arbitrators relied in any way upon BREAKERS' Guarantee in making their award. The trial court's order of July 12, 1991 was reversed by the Opinion below. Petition, Appendix B.

2. Opinion Below:

BREAKERS misstate the opinion below. There was no finding that the agreement was a *"D'Oench, Duhme* type contract." The Court of Appeal's November 6, 1992 reversal of the trial court's July 12, 1991 Order vacating the arbitration award was on *two* separate independent grounds. *First,* none of the California statutory grounds for vacating arbitration awards exist in this case. Petition Appendix B, page B-14. *Second,* since BREAKERS did not contend that the alleged illegality constituted grounds to revoke the entire contract or that the alleged illegality voided the arbitration clause in the contract, they *waived* the illegality issue by failing to raise it at any time prior to an adverse arbitration award under the rule stated in *Moncharsh v. Heily and Blase,* 3 Cal.4th 1, 10 Cal.Rptr.2d 183 (1992). Petition, Appendix B, pages B-16-18.

II. SUPPLEMENTAL STATEMENT OF THE CASE

The Petition omits critical facts and contains false statements. The true facts are as follows:

1. In March *1983*, BREAKERS, obtained a $16 million real estate development loan from HOME Federal Savings and Loan Association (hereinafter "HOME") for the purchase of land and the construction of an apartment project in Huntington Beach, California (hereinafter "Project"). In connection with this loan, BREAKERS executed a Promissory Note, Loan Agreement, Construction Loan Agreement and a *first priority* Deed of Trust recorded on March 11, 1983, to secure the loan. DRIVER was *not* the contractor at the time of the loan, and did *not* then or at any time sign any of the loan documents. In *1989*, the loan from HOME *was paid in full*; HOME's deed of trust was released, and HOME has no further interest in the Project or the property.

2. On or about July 15, *1983*, BREAKERS entered into a written contract with Acacia Construction (hereinafter "ACACIA"), a general building contractor, for the construction the Project. ACACIA worked on the Project from July, 1983, through March, 1984, performing grading, installing concrete piles, etc., of a value of approximately $500,000.

3. In February *1984*, ACACIA informed BREAKERS that its present estimate indicated construction costs would be at least $10.1 million and that this estimate was qualified and based upon still incomplete plans for the Project.

4. In *March-April 1984*, BREAKERS discharged ACACIA as contractor and changed architects, structural engineers and civil engineers, and asked DRIVER to assist them in the Project. BREAKERS also informed DRIVER that they were changing the plans to reduce the

construction costs to the approximate balance of $8.6 million remaining in their construction budget, that all of the principals and owners of BREAKERS would personally guarantee and agree to pay DRIVER any construction costs over the $8.6 million, and that BREAKERS had several methods of raising additional monies to make up the difference between the $8.6 million budget and the actual costs of construction.

5. Thereafter DRIVER received from BREAKERS a letter dated *April 18, 1984,* setting forth the various methods BREAKERS had in process and would use to make up the shortage of construction funds, including obtaining secondary financing and syndication, and instructing DRIVER to *"consider this (letter) as your notice to proceed"*. On *April 30, 1984,* DRIVER, began its first physical work on the Project with its own forces.

6. In April, 1984, at the request of BREAKERS, DRIVER put the project out for bid, using the still incomplete plans dated January 9, 1984 or earlier, and marked "Not for Construction". As a result of subcontractor bids and estimates by DRIVER's staff, DRIVER came up with an estimated cost of $11,519,794. Thereafter, at a meeting held on April 27, 1984, BREAKERS came up with their own estimate in the approximate amount of $10.6 million, based upon BREAKERS making several cost saving changes, some of which were already in process by their new architects and engineers.

7. *At the instruction of* BREAKERS' Steven Semingson, DRIVER on May 1, 1984 prepared a *standard AIA form Cost Plus Construction Contract* (hereinafter "Construction Contract") in the amount of $8.6 million and

had its attorneys prepare BREAKERS' Guarantee and Indemnity Agreement (hereinafter BREAKERS' Guarantee) in the maximum amount of $11 million. At the time, BREAKERS promised DRIVER that major cost saving changes in the plans would be made by BREAKERS' new design team. BREAKERS' Guarantee specifically stated that BREAKERS and DRIVER were *"working together on revisions to the plans and specifications for the project in an effort to bring lower the final costs of the project plus Contractor's fees, to as close as possible to the present GMC ($8.6 million)."* As it later turned out, DRIVER's efforts to reduce construction costs *downward* to the $8.6 million, were frustrated by BREAKERS' constant demands, additions, changes, delays, disruptions and interferences, and the enormous power and control BREAKERS exercised over DRIVER, subcontractors, architects and engineers and nearly every aspect of the Project, including the design, DRIVER's pay applications, the construction, changes, timing, subcontracts and materials. An example of BREAKERS' arbitrary control over DRIVER's pay applications is indicated in HOME's inspector's site report of August 6, 1985, wherein he stated in the first paragraph on page 2:

> "Please note that the percentage of completion dropped from the previous month, from 85% to 82%. In our opinion, the project is approximately 90% completed. No Application for Payment was made for any of the items shown in Change Order #5. Much of this work is completed."

8. Prior to the Construction Contract and BREAKERS' Guarantee, signed on May 4, 1984, DRIVER

had *no* contractual obligations or agreements with BREAKERS. The Construction Contract was a standard form (A111 and A201) of the American Institute of Architects widely used throughout the United States for decades, and contained a separate paragraph 7.9 in the General Conditions (AIA form A201) entitled "ARBITRATION". In addition the word "arbitration" is used in many paragraphs throughout the General Conditions. BREAKERS' contention on page 4 of their Petition that there was a hidden arbitration clause buried in an attachment is simply not true, nor was any such contention ever previously made by BREAKERS.

9. It was undisputed that BREAKERS' Guarantee was prepared *at the request of BREAKERS' Mr. Semingson* and contained therein the information and details he had furnished to DRIVER. At all times, DRIVER believed that BREAKERS' Guarantee was valid and enforceable, and it was always DRIVER's belief that the Lender, HOME, *was aware* of BREAKERS' Guarantee as particularly stated therein *in* the second full paragraph on page 2 thereof as follows:

> "*WHEREAS, Lender is aware* that as between Owner and Contractor, *Owner will be required to pay* any increased costs resulting from any revisions and modifications required by the City of Huntington Beach, as well as for any changes and extra work as provided in the Construction Contract and *for any excess of Contractor's actual costs plus Contractor's fee over the present GMC,*(**$8.6** million) and *that Owner will be executing this Guarantee and Indemnity Agreement, so providing* as more particularly set forth below;" (Emphasis added.)

10. When BREAKERS, et al., on May 4, 1984 signed their Guarantee, they agreed and represented to DRIVER, that *the Lender* (HOME) *was aware of BREAKERS' Guarantee* and its provisions and *that BREAKERS would be signing it*. DRIVER relied upon these representations and provisions in BREAKERS' Guarantee in constructing BREAKERS' Project.

11. BREAKERS' Guarantee was *not* a secret second agreement; it was known to HOME and was simply a *guarantee* given to DRIVER by BREAKERS, et al., guaranteeing that *if* sufficient revisions in the plans and specifications *were not made by BREAKERS* to get the cost of the Project down to $8.6 million, DRIVER would be paid for its actual construction costs, not exceeding $11 million by the persons and entities who signed the Guarantee. Unfortunately, BREAKERS did not cooperate in making revisions to lower the costs, but instead made many additions to the Project totalling $2,741,162.

12. BREAKERS' Guarantee did *not* "ostensibly increase . . . the exposure of the S&L (HOME) from $8.6 million to $11 million" as contended in the Petition at page 3. HOME's deed of trust securing the loan to BREAKERS had been recorded on *March 11, 1983*, more than a year before the Construction Contract and BREAKERS' Guarantee were signed on *May 4, 1984*, and thus HOME's previously recorded deed of trust had *priority* over any mechanic's lien rights DRIVER might have on the Project. In fact, *the value of HOME's security* for its loan to BREAKERS *would be increased* by any improvements DRIVER made to the Project, and DRIVER would not have any security by way of mechanic's lien rights for the improvements it was to make to the Project *until the*

value of the Project *exceeded* the amount of HOME's ($16 million) loan and first priority deed of trust. Thus, BREAKERS' Guarantee, could in no way harm HOME or any governmental agency but *on the contrary would greatly benefit HOME* and its security. In fact, at the arbitration trial, BREAKERS contended they had a 1985 appraisal showing a Project value on completion of *$29.5 million*. At the time of the May 4, *1984* BREAKERS' Guarantee, HOME's *$16 million* loan to BREAKERS had already been approved and funded *in 1983* and draws out of the loan had been made by BREAKERS to purchase the land, to pay ACACIA, etc. The May 4, 1984 agreements did *not* increase the amount of money HOME agreed *in 1983* to loan on BREAKERS' Project and did *not* subject either HOME or any governmental agency to further risk or liability, but rather, HOME was extremely benefitted by DRIVER's willingness to go to work and get the Project going again at a time when everyone involved knew that the construction loan budget was insufficient to pay all of the remaining costs of construction *as then designed*. If the Project had not restarted, HOME would have been left with a parcel of land with some piles (for 18 buildings) in the ground and partially completed plans.

13. At the arbitration hearing on June 22, 1989, Ms. Gloria Wolfe, HOME's Regional Manager of Construction Disbursement, *was sworn and testified*: that *she was shown BREAKERS' Guarantee* after a meeting held in San Diego *early in the job and before any major construction had started*, that *she knew the $8.6 million in the Construction Contract was not a real number*, and that *she believed* (as DRIVER had) *that BREAKERS' August, 1984, $2.52 million loan* (consented to by HOME) from Newport Balboa *was going*

to make up the difference between the $8.6 million in the Construction Contract and the $11 million in BREAKERS' Guarantee. There was no competent evidence that BREAKERS' Guarantee was not part of HOME's files as contended in the Petition at pp. 3-4. At the time of the alleged review of HOME files in 1991, many of HOME's files were missing as testified by HOME's representative at the arbitration trial on June 27, 1989. Further the 1991 review did not include 2 large boxes of HOME's files locked in a cabinet at the American Arbitration Association. Nor was there any evidence that the Construction Contract was in HOME's files or was in any way relied upon by HOME.

14. DRIVER had *no* agreements or dealings with HOME, and DRIVER's sole knowledge of what HOME might know or require was from BREAKERS' Mr. Semingson. No payments were made by HOME directly to DRIVER with respect to the Project, and HOME made all loan payments directly to BREAKERS. DRIVER made no representation to HOME that it would construct the Project for the funds remaining in the loan as alleged in the Petition at page 4.

15. The $8.6 million cost plus Construction Contract was increased by Change Orders, and by Change Order No. 5, dated July 15, 1985, *signed both by DRIVER and BREAKERS*, the Construction Contract had been adjusted to *$10,742,367.09*. In addition, Change Orders No. 6 and 7, signed by DRIVER and submitted to BREAKERS for signature and payment, increased the Construction Contract to *$12,449,161*.

16. Further, the evidence introduced at the 130 day arbitration trial showed that DRIVER performed *extra and additional work* out of the scope of the Construction Contract, in the amount of *$2,741,162* and that DRIVER had only been paid by BREAKERS the sum of *$9,363,269.78*. The Arbitrators made their decision based upon the evidence and awarded DRIVER for work performed the sum of *$1,575,535.00*, which is less than the *$1,977,892.22* difference between $8.6 million plus said *$2,741,162* (for extra work) less the $9,363,269.78 paid.

17. The trial court on March 16, 1986, ordered BREAKERS to arbitrate. The arbitration commenced in the American Arbitration Association *in June, 1986*, and *after over 130 days of arbitration trial*, resulted in a $3,021,502 Award (including interest, costs and attorneys fees) on October 4, *1990*, in favor of DRIVER and against BREAKERS.

18. BREAKERS and their attorneys at all times *prior* to the October 4, 1990 Arbitration Award and their 1991 Petitions to Vacate the Award, contended and asserted in both the Trial Court and in the arbitration that their May 4, 1984 Guarantee was valid and enforceable and provided BREAKERS the basis for their request for attorneys' fees in the arbitration and in the trial court. In fact, until BREAKERS' said 1991 Petitions, BREAKERS, et al., in signing BREAKERS' Guarantee, agreed to and represented to DRIVER the truth of all of the statements and provisions in their Guarantee, including the statement that the "Lender is aware that . . . Owner (BREAKERS) will be executing this Guarantee . . . " *After* BREAKERS lost the four year arbitration, they now say *"they lied," and* they now request the Court to reward them for *their*

(alleged) lie, by giving them a *$1,575,535 windfall* by not having to pay DRIVER *the $1,575,535 balance found to be due* by the Arbitrators *for work performed by DRIVER on their Project.*

19. The evidence at the arbitration trial also showed that BREAKERS' partners drew out $1,196,359 of project funds during construction , and steadfastly refused to invest any of *their own* money, and yet, BREAKERS ended up with a Project *they testified* had a completed value of *$29,500,000* in 1985, at the time they sold up to a fifty percent (50%) of their equity to Pacific Real Property (Pacific Federal) in *August, 1985* for *$5,500,000.00.*

20. BREAKERS' arbitration trial Exhibit HB16-153 and as testified to by BREAKERS' managing partner, Semingson, showed that the construction budget was simply the amount left over out of the $16 million HOME development loan and was not based upon any real estimate of construction costs.

III. SUMMARY OF ARGUMENT

The subject transaction and the resulting arbitration and appellate decisions do not violate the principles set forth in *D'Oench, Duhme & Co., Inc. v. FDIC,* 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942) and its progeny. HOME had full knowledge of the transaction, never suffered any potential or actual damages with respect to the transaction, and was paid in full. During the arbitration of this matter between DRIVER and BREAKERS, BREAKERS never raised the issue of illegality or claim that BREAKERS' Guarantee was unenforceable.

In fact, during the arbitration, BREAKERS sought to enforce BREAKERS' Guarantee through their claim for attorneys' fees. It was only *after* the Arbitrators ruled against BREAKERS and in favor of DRIVER that any alleged issue of illegality was raised. Without any showing that the Arbitrators relied on BREAKERS' Guarantee, the trial court, nevertheless vacated the arbitration award on the basis of partial illegality. The California Court of Appeal reversed the trial court on two grounds. The California Court of Appeal properly held that no statutory grounds exist for vacating the Award and that, since BREAKERS' claim of illegality went to only a portion of the contract, any such claim not raised during the arbitration was deemed waived. Under California law, issues of partial illegality are subject to arbitration. *Moncharsh, supra*, 3 Cal.4th at 30; *Green v. Mt. Diablo Hospital District*, 207 Cal.App.3d 63, 71, 254 Cal.Rptr. 689 (1989). Further, BREAKERS does not have the standing to raise any claim of the violation of "non-party" rights.

BREAKERS rely upon *Pitts v. Highland Construction Co.*, 115 Cal.App.2d 206, 252 P.2d 14 (1953), *Young v. Hampton*, 36 Cal.2d 799, 228 P.2d 1 (1951) and *McAllister v. Drapeau*, 14 Cal.2d 102, 92 P.2d 911 (1939). Those cases are distinguishable from the within action in that in those cases there was no arbitration involved, the lenders had no knowledge of the second agreement, the second agreement did not state on its face that the lender was aware of the second agreement, there was no evidence at the trial that the lender was aware of the second agreement, the parties seeking to enforce the second agreement were involved in the financing of the transaction, and there was no issue of waiver involved. Further, the within

action is virtually identical to *Shiver v. Liberty Building-Loan Association*, 16 Cal.2d 286, 106 P.2d 4 (1940), wherein the Court found the second agreement to be valid and enforceable.

BREAKERS further claim that the policies set forth in *D'Oench* and *Federal Savings & Loan Insurance Corp. v. Gemini Management*, 921 F.2d 241 (9th Cir. 1990) would not be served if *Moncharsh* is deemed controlling. However, such a claim is erroneous. First, in general, state courts and arbitrators have the jurisdiction to hear and decide all federal issues presented to them, absent specific legislation or United States Constitution provisions to the contrary. Second, unlike the within action, the *D'Oench* and *Gemini* cases are based upon (1) the bank having no knowledge of the alleged "illegal" transaction, and (2) by the lack of such knowledge, the bank was misled into making the loan. Third, BREAKERS cannot show that the Arbitrators relied upon BREAKERS' Guarantee in rendering their award. Based thereon, the Petition For Writ of Certiorari must be denied.

IV. ARGUMENT

A. THE ALLEGED LEGALITY OF BREAKERS' GUARANTEE WAS NOT REQUIRED TO BE CONSTRUED BY THE COURT OF APPEAL IN RENDERING ITS DECISION

As previously stated, the Court of Appeal held that there were *two* reasons why the trial court's order vacating the arbitration award must be reversed. The first reason given was that "None of the statutory grounds for

vacating the award [*California Code of Civil Procedure* § 1286.2] exists here. Thus the order vacating the award must be reversed" (Petition, Exhibit B, p. B-14).

The Court of Appeal, as "a second reason . . . for reversing the (Trial Court) order" (*id.*), followed the holding of *Moncharsh v. Heily & Blase, supra.* In *Moncharsh,* the California Supreme Court held, among other things, at page 31, as follows:

> "We thus hold that unless a party is claiming (i) the entire contract is illegal, or (ii) the arbitration agreement itself is illegal, he or she need not raise the illegality question prior to participating in the arbitration process, so long as the issue is raised before the arbitrator. Failure to raise a claim before the arbitrator, however, waives the claim for any future judicial review."

BREAKERS contend that notwithstanding the above-quoted language of *Moncharsh,* that the Court of Appeal was required to, but did not, construe the legality of BREAKERS' Guarantee. The Court of Appeal found that since BREAKERS claimed that their Guarantee was only partially illegal, their claim of illegality was waived because it was not raised during the arbitration.

In *Moncharsh,* the Supreme Court recognized an extremely limited exception "in rare cases when according finality to the arbitrator's decision would be incompatible with the protection of a statutory right." *Moncharsh,* at 32, *citing Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987). In *Shearson,* the Court held that federal statutory claims are arbitrable under the Federal Arbitration Act *unless* a party opposing the arbitration shows that it was

the intent of Congress to preclude a waiver of judicial remedies for the statutory rights in issue. *Shearson*, 482 U.S. at 225-227.

BREAKERS' claim that the Court of Appeal did not consider the issue of illegality of BREAKERS' Guarantee, and therefore did not consider whether this case came under the *Moncharsh* exception for judicial review of arbitration awards involving claims of partial illegality in a contract. BREAKERS' claim is wholly without merit. First, the Court of Appeal *did* consider the extent of the alleged illegality with respect to the subject transactions between DRIVER and BREAKERS and found that since BREAKERS was arguing the *validity* of the attorneys' fees provision in BREAKERS' Guarantee, that therefore the illegality did not go to the entire transaction. Second, BREAKERS have not claimed that arbitration was not available for the resolution of the subject dispute due to enacted statutes. BREAKERS' claim of illegality does not attack the validity of the arbitration process, it only attacks one particular provision in BREAKERS' Guarantee, which obligated BREAKERS to pay up to $11 million, plus changes. Third, BREAKERS did not file a Petition for Rehearing before the Court of Appeal seeking review of the alleged omissions and misstatements in the subject opinion. Therefore, the Court of Appeal finding that BREAKERS waived any claim of illegality is correct.

B. AS THE HOLDING BY THE COURT OF APPEAL IS CONSISTENT WITH *MONCHARSH* AND PRIOR CASE LAW IN CALIFORNIA, THE PETITION MUST BE DENIED

The waiver rule in *Moncharsh*, that a party must first raise issues of illegality before the trier of fact is consistent with prior case law. In *Fomco, Inc. v. Joe Maggio, Inc.*, 55 Cal.2d 162, 166, 10 Cal.Rptr. 462 (1961), the defendants on their motion for a new trial for the *first time* raised the issue of illegality, i.e., the plaintiff did not hold a license required by Section 1263 of the *Agricultural Code*. The California Supreme Court affirmed the judgment for plaintiff and distinguished its earlier case, *Lewis & Queen v. N.M. Ball Sons*, 48 Cal.2d 141, 308 P.2d 713 (1957), stating at page 166:

> "*Lewis & Queen v. N.M. Ball Sons*, 48 Cal.2d 141 [308 P.2d 713], relied on by defendants, is not here on point. In that case the issue of illegality was first raised *during the trial* and not for the first time on a motion for a new trial. (Emphasis in original).
>
> "None of the decided cases hold that after a judgment has been entered without any evidence having been introduced establishing illegality, the court must grant a motion for a new trial on the ground of newly discovered evidence of illegality even though the moving party has failed to show the exercise of the diligence required by section 657, subdivision (4), of the *Code of Civil Procedure*."

Thus, the California Supreme Court in *Fomco*, in *1961*, rejected the contention that a party can wait until *after* they lose in court or arbitration, to first raise the issue of

illegality. Based thereon, *Moncharsh* did not change a long standing rule of law, but rather followed prior law.

In *Green v. Mt. Diablo Hospital District*, 207 Cal.App.3d 63, 254 Cal.Rptr. 689 (1989), the Court of Appeal analyzed the illegality issue with respect to arbitrations. The court stated:

> "To avoid arbitration, the illegality 'must be such as renders the entire contract illegal and unenforceable; and that *a claim of illegality of one of the incidental clauses of the contract that fall short of affording ground for revocation of the contract is itself subject to arbitration.*' (*California State Council of Carpenters v. Superior Court* (1970) 11 Cal.App.3d 144, 157 [89 Cal.Rptr. 625].)" (Emphasis added.)

Green, 207 Cal.App.3d at 71; *accord*, *Moncharsh*, 3 Cal.4th at 30.

Thus, through *Green* in 1989, *Carpenters* in 1970 and *Fomco* in 1961, BREAKERS were put on notice that issues of illegality concerning the transaction had to be raised no later than in the arbitration trial. For BREAKERS to take the position that they were not required to raise the illegality issue on DRIVER'S Motion to Compel Arbitration in 1986, or during the 1986-1990, 130 day arbitration trial would be antithetical to the rule that arbitrators have broad powers and the power to decide and determine all issues relevant to the transaction. In *Pacific Vegetable Oil Corp. v. C.S.T., Ltd.*, 29 Cal.3d 228, 241-242, 174 P.2d 441 (1946), the California Supreme Court, in construing the predecessor statute [former *California Code of Civil Procedure* § 1288] to *California Code of Civil Procedure* § 1286.2,

held that where arbitrators consider all the evidence submitted to them and do not deny a party the right to submit evidence and present its case, no ground for vacating the award exists under the controlling statute. Further, BREAKERS sought to enforce their Guarantee and the attorneys' fee provision therein during the arbitration and even in their state appeal in Case No. G011659. Only after BREAKERS lost in the arbitration did BREAKERS first claim that a portion of their Guarantee was illegal. Without question, BREAKERS is attempting to engage in "procedural gamesmanship" which has been condemned as "undermining the advantages of arbitration." *Moncharsh*, 3 Cal.4th at 30; *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street*, 35 Cal.3d 312, 323, 197 Cal.Rptr. 581 (1983). BREAKERS should not be allowed to wait until after an adverse decision to first raise the issue of illegality. See *Lovret v. Seyfarth*, 22 Cal.App.3d 841, 859-860, 101 Cal.Rptr. 143 (1972), ("[a] claimant may not voluntarily submit his claim to arbitration, await the outcome, and, if the decision is unfavorable, then challenge the authority of the arbitrators to act.")

In *Moncharsh*, the California Supreme Court properly relied upon prior law in formulating its holding with respect to waiver of partial illegality claims. *Moncharsh*, 3 Cal.4th at 29-31. The rule in *Moncharsh* that the issue of illegality be raised before or during the arbitration, is sound. The issue of illegality must be raised at that time in that it puts the parties and arbitrators on notice of that issue. A more meaningful hearing can then be held to enable the arbitrator's search for the truth. As the vast

majority of arbitration awards do not have findings, raising the illegality issue at the outset gives the parties and arbitrators the opportunity to fully preserve the issue for any later judicial review. Otherwise, a meaningful review of the arbitration award on the issue of illegality cannot be had under *California Code of Civil Procedure* § 1281 *et seq.*, in that one can only speculate as to what would have been arbitrator's findings on the illegality issue. Any such speculation would be contrary to the strong public policy in favor of finality of arbitration proceedings. In order to rule upon the partial illegality issue, the court will, in effect, be required to retry the merits of the controversy. This would be completely contrary to the general rule that errors of fact and law by the arbitrator are not reviewable by the courts.

C. THERE ARE NO THIRD-PARTY OR NON-PARTY PUBLIC INTERESTS ADVERSELY AFFECTED BY THE OPINION BELOW

In California, a plaintiff must be the real party in interest with respect to the claim sued upon. In general, every action must be prosecuted in the name of the real party in interest. *California Code of Civil Procedure* § 367. Generally, a real party in interest is a person who has the right to sue under the substantive law. It is the person who owns or holds title to the claim or property involved, as opposed to others who may be merely interested or benefited by the litigation. *Gantman v. United Pacific Insurance Co.*, 232 Cal.App.3d 1560, 1566, 284 Cal.Rptr. 188 (1991).

BREAKERS claim that the rights of non-parties will be adversely affected if the *Moncharsh* rule is followed in the within action. Not only are there no "non-parties" adversely affected, BREAKERS' claim is completely contrary to California law. The protection of the nebulous "rights of non-parties", even those who have not instituted legal proceedings, will be served if illegality is required to be raised at the outset. Because of the nature of the analysis required regarding illegality based on public policy, the rights of the parties and those rights of non-parties are necessarily considered. If illegality is raised during arbitration proceedings, arbitrators will then consider the merit of the illegality issue and any overriding issues of public policy in making their award, thereby promoting judicial economy. The rights of non-parties, i.e., public policy, will be analyzed and adjudicated in the arbitration and, if necessary, in subsequent court proceedings. If a party is allowed to wait until *after* an unfavorable arbitration award to first raise the issue of illegality, public policy will not be served, because, *first* the arbitrators would be denied the opportunity to decide the issue and *secondly*, had the award been favorable, the issue of illegality would *never* be raised. Thus, public policy is much better served by forcing the parties to raise the issue of illegality at the first opportunity, rather than permitting a party (like BREAKERS) to engage in "procedural gamesmanship" (*Moncharsh*, p. 30) to raise the issue only after an unfavorable arbitration award.

Further, *parties* who fail to raise the issue of illegality before or in the arbitration should not be able to use the ruse of claiming that the rights of *non-parties* were violated as a pretext to obtaining a new trial *for themselves*

after an unfavorable arbitration award. See, *Lovret v. Seyfarth*, 22 Cal.App.3d 841, 859-860, 101 Cal.Rptr. 143 (1972). This is especially true when non-parties, such as the Lender HOME involved in this case, has not been damaged, did not rely on the $8.6 million figure in the Construction Contract or any representations of DRIVER, had knowledge of BREAKERS' Guarantee, and has been paid in full. Simply put, under the facts of this case, there is no third party to be protected from anything.

BREAKERS rely upon *Pitts v. Highland Construction Co.*, 115 Cal.App.2d 206, 252 P.2d 14 (1953); *Young v. Hampton*, 36 Cal.2d 799, 228 P.2d 1 (1951) and *McAllister v. Drapeau*, 14 Cal.2d 102, 92 P.2d 911 (1939) for the proposition that courts must be allowed to review the illegality of transactions involving loans by banks or savings and loans, irrespective of any perceptions of illegality by the parties to the arbitration. BREAKERS claim that this line of cases will "die" if courts are no longer able to review contracts which are allegedly partially illegal. However, such a position is not well taken.

Pitts, *Young* and *McAllister*, are not on point. In all three cases, the claim of illegality was raised before the initial trier of fact and the party was involved in the transactions and the claimed misleading of a lender. None of these three cases involve arbitrations or the issues of waiver. California has a strong public interest in favor of finality of arbitration. As the issue of partial illegality is one that arbitrators have the power to resolve, it is imperative that the issue be raised either before or during the arbitration so that (1) all parties have the opportunity to be heard on the issue and (2) a fully informed decision can be made and (3) the trial and

appellate courts do not have to speculate as to what extent, *if any*, the alleged illegality had on the arbitrator's decision. See, *Adams v. Murakami*, 54 Cal.3d 105, 112, 284 Cal.Rptr. 318 (1991). ("Sound public policy weighs in favor of fully informed decisions, especially when a public interest is at stake.")

Further, in *Pitts*, the Court of Appeal reversed the trial court's Order which found the entire agreement illegal and unenforceable. The Court of Appeal severed the illegal portion of the transaction and enforced the valid portion of the transaction.

Without question, *Pitts*, *Young* and *McAllister* are cases which are clearly distinguishable from the within action. In those three cases, there was no arbitration involved, the lenders had no knowledge of the second agreement, the second agreement did not state on its face that the lender was aware of the second agreement, there was no evidence at the trial that the lender was aware of the second agreement, the parties seeking to enforce the second agreement were involved in the financing transaction, and there was no issue of waiver involved.

The California Supreme Court case of *Shiver v. Liberty Building-Loan Association*, 16 Cal.2d 296, 106 P.2d 4 (1940), is directly on point and could not be distinguished by BREAKERS in state court. In *Shiver*, like in the case at bench, there were two documents. Liberty, the holder of an existing $2,228 note and deed of trust, executed a "consent to take bonds" *letter* to the Home Owners Loan Corporation, a Federal agency (hereinafter "H.O.L.C.") agreeing to accept "in full settlement the sum of $1,579.00

face value of the bonds of (H.O.L.C.) . . . and thereupon . . . release all . . . claim . . . against said property." *Id.* at 298. Liberty also executed escrow instructions giving it a $300 note secured by a second deed of trust on said property. There was *no* express approval by H.O.L.C. of these escrow instructions or of the second deed of trust, and the only evidence at the trial of any such approval was the *oral* testimony of Liberty's manager that he had discussed the matter with H.O.L.C. while in their office. The homeowner testified he "had refused at all times during the refinancing negotiations to give . . . (Liberty) any consideration in addition to the bonds." *Id.* at 297. The California Supreme Court first held that oral evidence was admissible to show the true consideration, and that Liberty was not bound by the recitals of consideration in the writing (consent to take bonds *letter*) and then affirmed the trial court's finding (based on such oral testimony that the $300 note was executed with H.O.L.C's knowledge or consent) that the $300 note and second deed of trust were valid and enforceable. *Id.* at 299-300. The California Supreme Court also distinguished its one year earlier decision in *McAllister v. Drapeau,* 14 Cal.2d 102, 92 P.2d 911 (1939) (relied upon by BREAKERS) on the grounds that in *McAllister* the $1,300 note and second deed of trust therein involved *were unknown* to H.O.L.C. (*Id.* at 300.)

A comparison between the *Shiver* case and the case a bench shows that the issue of illegality was a very much closer question in *Shiver*. *First,* in *Shiver,* Liberty *was involved in the financing,* i.e., H.O.L.C. issued and gave bonds *to Liberty* in reliance upon Liberty executing the consent to take bonds letter releasing all claim "against

said property". Whereas, in the case at bench, DRIVER was not involved in the financing, had no dealings with the lender, had no contracts with BREAKERS until over a year later and all loan payments went directly to BREAKERS and none to DRIVER. *Second*, in *Shiver*, the only evidence that H.O.L.C. was aware of the $300 note and second deed of trust was the oral testimony of *Liberty's* manager that he had mentioned it while at the office of H.O.L.C. (which oral testimony was inconsistent with Liberty's Consent to Take Bonds letter); whereas in the case at bench, not only did BREAKERS' Guarantee expressly state that the Lender was aware of its contents and that BREAKERS were signing it, but the Lender's regional manager, Gloria Wolfe, testified *under oath* at the arbitration trial extensively about HOME's knowledge of BREAKERS' Guarantee and the $11 million figure therein and that she had seen BREAKERS' Guarantee early in the job and before any major construction had started. *Third*, in *Shiver*, Liberty's second deed of trust was recorded as a second lien against the owner's property; whereas in the case at bench, BREAKERS' Guarantee did *not* constitute a lien against BREAKERS' property. The *Shiver* case was followed in *Temple v. Corporation of America*, 71 Cal.App.2d 599, 163 P.2d 67 (1945).

BREAKERS claim that the policies set forth in *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942) and *Federal Savings & Loan Insurance Corp. v. Gemini Management*, 921 F.2d 241 (9th Cir. 1990) would not be served if *Moncharsh* is deemed to be controlling. However, such a claim is erroneous. First, state courts and arbitrators have the jurisdiction to hear and decide all federal issues presented to them, absent

specific legislation or United States Constitution provisions to the contrary. See *Tafflin v. Levitt*, 493 U.S. 455, 458-459, 110 S.Ct. 792, 795, 107 L.Ed.2d 887 (1990). Second, the *D'Oench* and *Gemini* cases are based upon (1) the bank having no knowledge of the "illegal" transaction, and (2) by the lack of such knowledge, the bank was misled into making the loan, unlike here where HOME had knowledge of BREAKERS' Guarantee, made its loan over a year *prior* thereto, and consented to a $2.52 million second loan and lien against the Project to make up the difference between the $8.6 million Construction Contract and the $11 million BREAKERS' Guarantee. Third, BREAKERS cannot and did not show that the Arbitrators relied upon BREAKERS' Guarantee in rendering their award. As the within action and the holdings of both the Arbitrators and the California Court of Appeal do not infringe upon any federal rights, the Petition for Writ of Certiorari must be denied.

V. CONCLUSION

DRIVER and BREAKERS entered into a valid Construction Contract with a valid arbitration agreement therein, and the arbitration award based thereon is valid. Further, since the (March, 1983) Lender was not misled and was fully aware of BREAKERS' Guarantee at or about the time it was executed in May, 1984, BREAKERS' Guarantee cannot be considered a "secret" or illegal agreement.

BREAKERS waited until after an unfavorable arbitration award, to first assert (in 1991) that a portion of their Guarantee is illegal on the grounds that *their representation and statement* in *their 1984 Guarantee* that the "Lender is aware that . . . Owner (BREAKERS) will be executing this Guarantee . . . ", *was a lie*. Under the doctrine of invited error and waiver, BREAKERS cannot now claim they lied in their 1984 Guarantee, and thereby benefit from their own (lie) wrong.

The cases of *D'Oench, Gemini, Pitts, Young* and *McAllister* are inapplicable in that the lender (HOME) had knowledge of BREAKERS' Guarantee, did not rely upon the $8.6 million GMC figure, and was fully paid. BREAKERS is simply seeking to avoid the payment of a just debt in the amount of $1,575,535 (plus interest, attorneys' fees and costs), which the Arbitrators found to be the balance due to DRIVER for work performed. See also *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 105 S.Ct. 2622 (1985).

The arbitration award is fully supportable on three theories (Change Orders to the contract, extra work performed and cost plus) totally separate and independent of BREAKERS' Guarantee.

Partial illegality claims not raised in the arbitration are waived. *Moncharsh* merely confirms prior California Law (*Fomco, Inc. v. Joe Maggio, Inc., supra*) and clarifies the statutory intent of *California Code of Civil Procedure* § 1281, *et seq.*

The Court of Appeal properly reversed the trial court's order vacating the arbitration award. Accordingly, BREAKERS' Petition for Writ of Certiorari should be denied in its entirety.

Dated: June 24, 1993

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